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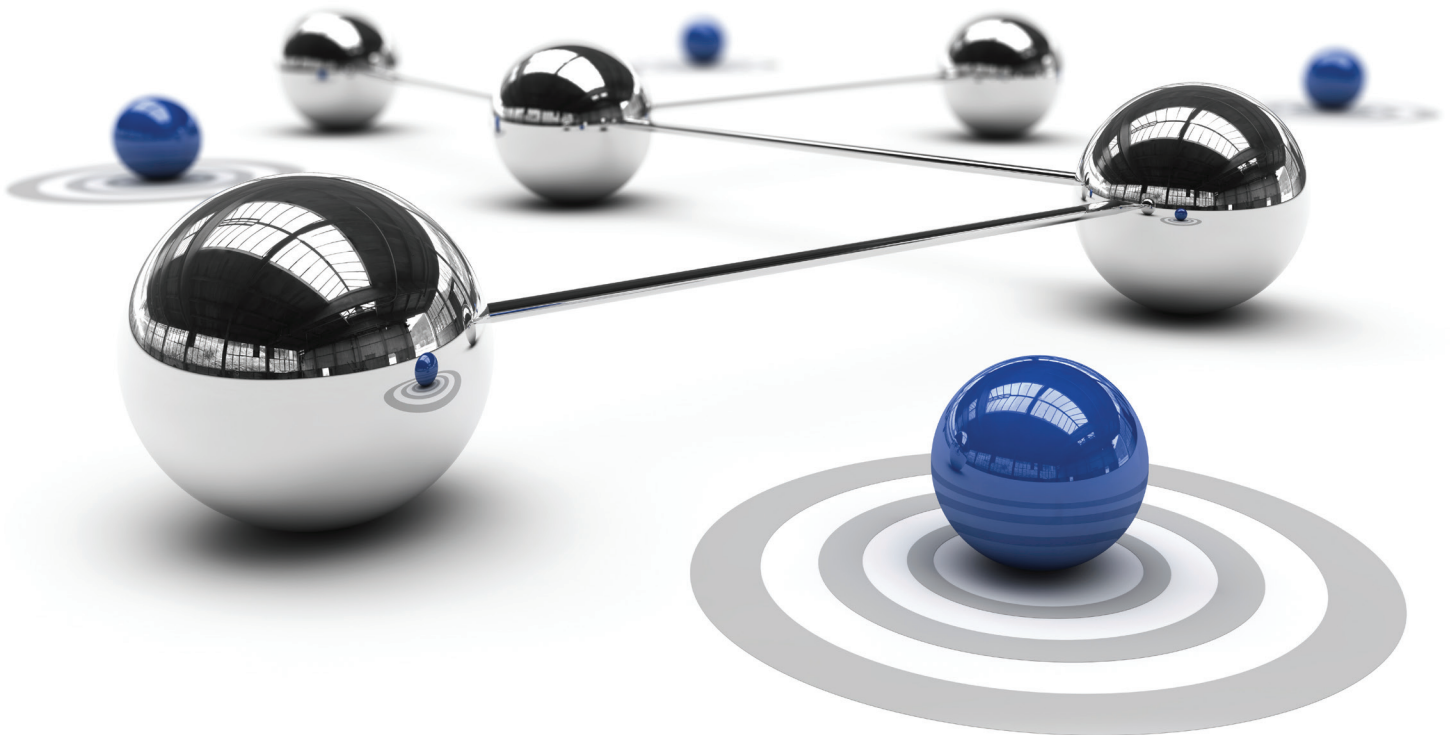
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# Which form of vertical relations makes you better off - Wholesale or Agency?<sup>1</sup>

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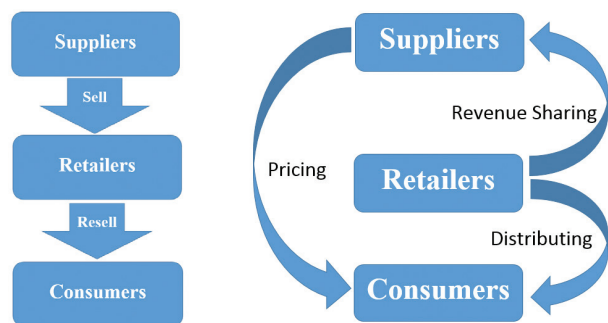
**Vertical relations in business do not all operate in identical ways. While the wholesale structure remains the common business format in the bricks-and-mortar environment, the prevalence of the agency structure in online markets indicates some transformations in supply and distribution chains. By examining and comparing the two structures, recent CCP research reveals the different preferences of suppliers and retailers over business formats, and explains why the rise of the agency structure implies a better position of retailers and how consumers may benefit from it.**

Today individuals rarely purchase goods directly from the manufacturer. We buy daily essentials from high street shops and supermarkets, as well as via a variety of online retailers. Goods are now starting to pass through more elaborate supply and distribution chains, with the majority of transactions rarely being achieved without the involvement of other parties. The vertical relations which characterise these supply and distribution chains operate in various ways which could have a positive or a negative effect on the consumer, making it important for us to understand what these effects are. Moreover, the choice of how a supply and distribution chain is structured in a particular industry may tell us something about the industry itself and is hence worthy of further study.

Among the various business formats observed in practice there are two common ones, a wholesale structure and an agency structure. Under the wholesale structure (Figure 1a), retailers buy from suppliers and resell to final consumers,

e.g., florists buy roses at flower markets and resell them in store. It is the suppliers who first set wholesale prices and then retailers set retail prices. Under the agency structure (Figure 1b), suppliers set prices and retailers merely help make transactions happen. In return, retailers receive shares of revenue specified by themselves in the first place, e.g., under fixed price listings, eBay sets a “final value fee” rate and receives a fraction of sellers’ total revenues.<sup>2</sup>

**Figure 1. The Wholesale Structure and the Agency Structure**



a. The Wholesale Structure    b. The Agency Structure

While the wholesale structure remains the standard in the bricks-and-mortar environment, the agency structure is becoming increasingly predominant in online markets with giant online retailers such as Amazon marketplace, Apple, eBay, Google and various booking websites adopting it. Recent theoretical studies tend to examine the agency structure alongside the (in)famous e-book case.<sup>3</sup> However, there is a lack of research providing a systematic analysis of the agency structure per se as well as detailed comparisons of the wholesale and agency structures, which constitute the basis of understanding the changes in vertical relations.

Elsewhere I have taken the initial steps towards this goal by comparing the outcomes under the two structures and examining firms’ preferences in relation to business format. Since competition intensifies as the goods and services available become more similar to each other, the degree of differentiation within each level of the vertically related market can also be translated to the degree of market power of firms in that level.<sup>4</sup> It would then be interesting to see how the relative degrees of market power affect firms’ preferences over business format, and whether that explains the popularity of one structure in certain markets.

In a simple representative model, I characterize the vertical relation first by the wholesale structure and then by the agency structure.<sup>5</sup> I find that retail prices are always lower under the agency structure, so it seems that agency pricing causes no per se harm. Was the Department of Justice then wrong to force publishers to move away from the agency structure for e-books despite the price rise when it was adopted? It is possible the price rise may plausibly have been driven by, among other factors, the Most Favoured Nation clauses adopted at the same time and which directly undermine the incentives for rival retailers to cut price.<sup>6</sup>

Regarding profitability, I find that suppliers always prefer the wholesale structure whereas retailers prefer the agency structure for a wider range of degrees of differentiation. This generally suggests that a vertically-related market would operate under the wholesale structure if suppliers possess relatively higher market power, and would operate under the agency structure if retailers possess relatively higher market power. Immediately, this explains why the agency structure is initiated by retailers in practice – suppliers never have the incentive to switch away from the wholesale structure. For large online retailers with strong network and negotiation power, their preferred business format may be part of the “take it or leave it offer” they have for suppliers where suppliers may be vulnerable and have no choice. For instance, it appears that it was Apple who persuaded publishers to adopt the agency structure.<sup>7</sup>

Moreover, my findings suggest that the relative profitability of the alternative schemes for retailers is sensitive to the degree of product differentiation at the supplier level: as long as it is not too low retailers are better off under the agency structure. This is interesting because it contrasts with our conventional understanding of the relationships between firms’

**“The relative profitability of the alternative schemes for retailers is sensitive to the degree of product differentiation at the supplier level: as long as it is not too low retailers are better off under the agency structure.”**

profitability and degrees of differentiation at different levels of the market. Given that they do not collude, firms in general would benefit from high degrees of differentiation at their own level and low degrees of differentiation at the other level of the market, such that they can exercise market power. This is true under the wholesale structure but not under the agency structure, as I find that retailers under the agency structure actually benefit from high degrees of differentiation at the supplier level. That is, the two parties’ incentives are better aligned under the agency structure.

In fact retailer profits, as well as industry profits, are maximized at the point of perfect differentiation at both levels of the supply and distribution chain characterized by the agency structure. That is, if degrees of differentiation at both layers of the market are high enough the agency structure is effectively a more efficient

business format. While competition authorities in general believe that competition benefits consumers the current study shows that, although firms engaging in the agency structure may have incentives that are better aligned, consumers can still benefit from lower prices compared to those under the wholesale structure, *ceteris paribus*.

Unlike the traditional views on vertical relations where retailers are often considered to be perfectly competitive and possess little market power, the rise of the agency structure

implies that retailers are in a strong position. Since suppliers are always better off under the wholesale structure and hence have no incentive to switch, retailers wanting to impose the agency contracts have to have relatively higher market power. As the degree of differentiation at the suppliers' level increases, retailer profits increase given the condition that the agency structure is in place, though this condition becomes more difficult to satisfy. This further indicates the considerable network and bargaining power of some online retailers.

1: This article is based on Lu, L (2015): "A Comparison of the Wholesale Structure and the Agency Structure in Differentiated Markets", CCP Research, forthcoming.

2: See eBay Seller Centre <http://sellercentre.ebay.co.uk/introduction-ebay-fees>.

3: In April 2010, five large book publishers in the US switched from the wholesale structure, which they used to have with Amazon, of selling e-books to the agency structure put forward by Apple. Following the price rise of e-books after the switch, the Department of Justice has lodged a complaint against Apple and publishers for their contractual agreements. For details see Competition Law Journal Concurrences No.3-2012 on "e-Books and the Boundaries of Antitrust", <http://ssrn.com/abstract=2140778>.

4: See Dobson, P. and M. Waterson (1996): "Product Range and Interfirm Competition," Journal of Economics and Management Strategy, Vol. 5, p. 317-341, and Dobson, P. and M. Waterson (2007) "The Competition Effects of Industry-Wide Vertical Price Fixing in Bilateral Oligopoly," International Journal of Industrial Organization, Vol. 25, p. 935-962.

5: The agency structure has also been characterized by Foros, Ø., H. J. Kind and G. Shaffer (2013) "Turning the Page on Business Formats for Digital Platforms: Does Apple's Agency Model Soften Competition?," Working Paper.

6: See Fletcher, A. and H. Morten (2014) "Retail Price MFNs: Are they RPM 'at its worst'?", CCP Working Paper 14-5.

7: See "Steve Jobs, Price Fixer?", The Wall Street Journal, March 12, 2012.

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